

Pre-Budget Report & the Economy

October 2007



- The Chancellor announced a lower forecast for economic growth in 2008. Although the Treasury's forecast for 2007 remains 0.2% higher than Consensus, at 3.0%, the Treasury's 2008 forecast was cut from 2.75% to 2.25%, which is also 0.2% above Consensus.
- The Treasury revised the savings ratio lower, to just 3.5% in 2007, but forecast this will increase to 4.25% by 2010. Household spending has also been revised lower in 2008, down from 2.5% to 2.0%.
- Gordon Brown's two fiscal rules are still met, although the new Chancellor has indicated that public sector borrowing will be higher than previously forecast and will push net borrowing higher as a percentage of GDP.

Alistair Darling delivered his first Pre-Budget Report on Tuesday 9th October 2007. In this analysis of that report, the Alliance Trust Research Centre focuses on the Treasury's new expectations for the global economy, the UK economy in particular and public finances, highlighting some of the assumptions behind these figures.

The updated forecasts for world trade growth suggest continued strength. World trade grew 10.0% in 2006, but the Treasury now estimates that trade will grow by 7.75% every year until 2010. Although a broad based slowdown is expected across all regions, trade is still expected to grow by more than its historical average. The UK's own export prospects appear slightly weaker, given the slower growth expected in the mature economies of the US and Europe. Expected growth in the UK's export markets in 2007 was held unchanged at 7.0%, but the Treasury now expects slightly lower growth of 6.5% in 2008 and 6.75% in both 2009 and 2010.

Global Economic Outlook

The Treasury decreased its forecast of economic growth in the G7 area from 2.5% to 2.0% in 2007, linked partly to the ongoing slowdown in the US. Growth prospects remain lower in 2008, at 2.0%, before returning to 2.5% in 2009 and 2010. Inflationary pressures are expected to remain broadly flat over the coming years, at 2.5%.

G7 Economic Outlook

	Actual 2006	Previous Forecast 2007	New Forecast 2007	Forecast 2008	Forecast 2009	Forecast 2010
% Change						
G7 Real GDP	2.75	2.5	2.0	2.0	2.5	2.5
CPI (Q4)	1.75	2.0	2.5	2.5	2.5	2.5
World Trade in Goods & Services	10.0	7.75	7.75	7.75	7.75	7.75
UK Export Markets	9.0	7.0	7.0	6.5	6.75	6.75

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Prospects for the UK Economy

The Treasury has had to concede that the economy is no longer growing at the rate previously forecast and it has now lowered its economic growth forecast for 2008, to 2.25%, following growth of 3.0% in 2007.

- The new 2008 growth forecast is now below trend, partly due to a weaker outlook for both personal consumption and manufacturing.
- Consumption is expected to grow 3.0% in 2007, but to then slow to growth of just 2.0% in 2008.
- The savings ratio has also been revised dramatically lower from 5.5% to just 3.5% in 2007, and is only expected to increase to 4.25% by 2010.
- Government spending growth is expected to increase by 2.5% both this year and next but by just 2.0% in 2009 and 2010.
- Growth in fixed investment in 2007 has also been revised downwards, from the previous forecast of 6.75%, to 5.75% in 2007, followed by much weaker growth of just 3.5% over the period from 2008-2010.
- Growth in both exports and imports has been revised lower for 2007 and these are also now expected to grow at a slower pace in the years ahead.
- The final revision came in the case of the balance of payments, with the deficit being revised down by £4.0bn, to £41.0bn in for 2007.

The Treasury's downgraded 2008 economic outlook produces forecasts which look more realistic, even though these remain above the Consensus. The

UK Economic Prospects

% Change	Actual 2006	Previous Forecast 2007	New Forecast 2007	Forecast 2008	Forecast 2009	Forecast 2010
GDP	2.75	2.75-3.25	3.0	2.0-2.5	2.5-3.0	2.5-3.0
Manufacturing Output	1.25	1.75-2.0	1.0	1.5-2.0	1.75-2.25	1.75-2.25
Household Consumption	2.0	2.25-2.75	3.0	1.75-2.25	2.25-2.75	2.25-2.75
Savings Ratio	5.0	5.5	3.5	3.75	4.0	4.25
Government Consumption	2.0	2.5	2.5	2.5	2.0	2.0
Fixed Investment	8.25	6.5-7.0	5.75	3.25-3.75	3.25-3.75	3.25-3.75
Exports of Goods and Services*	7.0	5.25-5.75	3.25	4.5-5.0	4.75-5.25	4.75-5.25
Imports of Goods and Services*	6.75	5.0-5.5	3.75	3.75-4.25	4.0-4.5	4.0-4.5
Balance of Payments (£bn)	-42.0	-37.0	-41.0	-41.0	-42.5	-44.25
Inflation (CPI) Q4	2.75	2.0	2.0	2.0	2.0	2.0

* Excluding missing trade intra-community fraud (MTIC)

Fiscal Rules

	Actual 2006/7	Previous Forecast 2007/8	New Forecast 2007/8	Forecast 2008/9	Forecast 2009/10	Forecast 2010/11
2010/11						
Current Budget Surplus /Deficit (£bn)	-4.7	-4.3	-8.3	-4.0	3.0	9.0
Cyclically adjusted surplus (% of GDP)	-0.2	-0.3	-0.7	-0.2	0.3	0.6
Public Sector Net Borrowing (£bn)	31.0	33.7	38.0	36.0	31.0	28.0
Net Borrowing as % of GDP (cyclically adjusted)	2.2	2.4	2.8	2.4	1.9	1.7
Public Sector Net Debt (% of GDP)	36.7	38.2	37.6	38.4	38.8	38.9
Deficit under Maastricht Definition as % of GDP (cyclically adjusted)	2.4	2.5	3.0	2.7	2.3	2.1
Debt Ratio re Maastricht Treaty (% of GDP)	43.4	44.3	43.9	44.8	45.1	45.3

Treasury appears to have factored in a softening in global economic growth. Upside cost pressures from food and oil prices will be countered by downside pressures from past monetary policy tightening and below trend growth in 2008. Inflation is expected to remain close to its target level of 2% throughout the entire forecast period.

Public Finances

The latest forecasts from the Treasury imply a slight deterioration in public finances. The current budget deficit had been expected to reach £4.3bn in the fiscal year 2007/8, but this Pre-Budget Report now estimates that this deficit will be much higher, at £8.3bn. The Treasury now expects the current budget deficit to move into positive territory by 2009/10, which is 12 months later than had been forecast previously. However, budget surpluses of £9bn by 2010/11 and £13bn by 2011/12 are expected and the new Chancellor still expects to meet Gordon Brown's 'golden rule', which requires that

the current budget be zero or slightly positive over the cycle.

Public sector net borrowing, as a % of GDP, is not expected to improve by as much as had been forecast at the time of the Budget Report. In 2006, net borrowing was just 2.2% of GDP, but this is currently forecast to increase to 2.8% this year. Net borrowing in 2007 is forecast to be £4bn greater than previously expected, rising to £38.0bn. However, despite this, improvements in the ratio of net borrowing to GDP ratio are still expected to be achieved over the next 3 years, causing it to decline to just 1.7% by 2010/11.

Public sector net debt is now expected to be little changed from the previous Treasury forecast. The ratio of public sector net debt to GDP was lower than expected in 2006/7 at 36.7% of GDP, but this ratio is now expected to increase fairly steadily, to 38.9% by 2010/11. Although this is higher than the previous forecast of 38.8%, it still ensures that the Chancellor meets the 'sustainable investment' rule. This rule requires that public sector net debt remains lower than 40% of GDP.

Comprehensive Spending Review

As expected the new chancellor outlined tighter public spending plans over the next three years, with an average real growth in spending of just 2.1%. Health spending will increase by 4.0%, children, schools & family spending will increase by 3.1% and defence spending will rise by 1.5%. An estimated £30bn of efficiency savings will be made by 2010/11.

Source: HM Treasury, Consensus